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Supreme Court, U.S.
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No. 98-542

In The

Supreme Court of the United States

October Term, 1998

DARREL D. SMITH,

Petitioner,

v.

JOHN PETER LEE, LTD., TOM GRIMMETT, Chapter 7 Trustee,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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REPLY BRIEF

Petitioner Darrel D. Smith hereby replies to the briefs in opposition to certiorari filed by Respondents John Peter Lee, Ltd. and Tom Grimmett. Neither Respondent has refuted the basis upon which Smith seeks this Court's review – the Ninth Circuit's perpetuation of significant conflicts regarding two important issues of bankruptcy law: (i) whether Bankruptcy Code section 1141(b) permits a plan of reorganization to limit the revesting of assets in the reorganized debtor by implication, instead of by express language, and (ii) whether the conversion of a chapter 11 case to a chapter 7 liquidation can divest the reorganized debtor of assets that had revested in him upon confirmation of his plan of reorganization. At least with respect to the second issue, Respondent Grimmett *concedes* that a conflict with the Sixth Circuit and other courts does exist. Grimmett at 19.

Instead of addressing the issues raised in the Petition and in the decisions below, Respondents argue irrelevant factual points and meaningless distinctions between the cases. They also downplay the significance of "[t]he enormous confusion" in the case law that has led the courts to "mindboggling" results in this important area of bankruptcy law. *See* 4 *Norton Bankruptcy Law & Practice* § 95:12 at Supp. 172-73 (1998) (hereinafter "*Norton*").

A. The Ninth Circuit's Holding That The Estate's Assets Did Not Revest In Smith Was Central To That Court's Decision, And Its Resolution Of The Issue Directly Conflicts With The Holdings Of Other Courts.

The Ninth Circuit's opinion centers principally on whether Smith's assets revested in him upon confirmation of his Plan[1] under Bankruptcy Code section 1141(b). *See* Petition at 4a-6a. Although no provision in Smith's Plan limited the revesting of his assets, the Ninth Circuit held that a

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[1] Capitalized terms have the same meaning as in the Petition.

limitation on revesting could be *implied* from various unrelated Plan provisions. According to the Ninth Circuit, "[a] plan may prevent such vesting even if '[t]he plan does not state in unambiguous terms that property of the estate does not revest in the debtor.' " *See* Petition at 5a (quoting the Ninth Circuit's prior decision in *In re Hillis Motors, Inc.*, 997 F.2d 581, 589 (9th Cir. 1993)).

As demonstrated in the Petition, the Ninth Circuit's holding directly conflicts with the majority rule that assets in the debtor's bankruptcy estate "vest[ ] automatically upon plan confirmation" absent specific contrary provisions in the plan, *Harstad v. First American Bank*, 39 F.3d 898, 902 (8th Cir. 1994), and that a plan must "explicitly state" that it is limiting the revesting of assets in the debtor, *Prince v. Clare*, 67 B.R. 270, 272 (N.D. Ill. 1986).[2] These holdings are consistent with "the usual rule of statutory construction that an exception which carves out something which would otherwise be included must be strictly construed." *United States v. J.E. Mamiye & Sons, Inc.*, 665 F.2d 336, 340 (C.C.P.A. 1981).

Neither Respondent attempts to refute the conflict among the courts as to the proper interpretation of section 1141 and the law of revesting. Instead, Lee mischaracterizes the revesting issue as "irrelevant," and even goes so far as to include in his list of supposedly "inapplicable" authorities the Ninth Circuit's decision in *Hillis*, *supra*, the *sole* substantive precedent cited anywhere in that court's opinion below. Lee at 11.

Lee's contention is preposterous, given that the revesting issue was at the heart of the Ninth Circuit's decision. By holding that Smith's assets did not revest upon confirmation, the Ninth Circuit thereby believed it was able to dismiss the majority line of cases holding that a Bankruptcy Court may not convert a chapter 11 case to one under chapter 7 once the

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[2] *See also In re Pauling Auto Supply*, 158 B.R. 789, 795 (Bankr. N.D. Iowa 1993) ("Absent an express provision postponing the revesting, the court will not imply it from vague and ambiguous provisions of the plan."); *In re Grinstead*, 75 B.R. 2, 3 (Bankr. D. Minn. 1985) ("Once a plan of reorganization is confirmed, the bankruptcy estate ceases to exist unless the plan specifically provides otherwise. . . . ").

estate's assets have revested in the reorganized debtor. If the assets had in fact vested in Smith, as the Bankruptcy Court had found, then Smith's case could not have been converted under the majority rule. *See* Petition at 21-23.

Lee's manner of "distinguishing" cases is equally unpersuasive. In case after case, Lee identifies some irrelevant fact that has nothing to do with the application of the revesting provisions in Bankruptcy Code section 1141(b). For example, Lee terms as "inapplicable" the Eighth Circuit's decision in *Harstad*, *supra*, for the stated reason that it "was not a conversion case." This is a distinction without a difference. The significance of *Harstad* is not for the law of conversion, but rather for its holding that a court may not infer a limitation on section 1141(b) revesting from a plan's jurisdictional provisions. The Eighth Circuit's holding squarely rejects the reasoning employed by the Ninth Circuit in this case. Thus, *Harstad* is no less relevant because it did not involve a post-confirmation conversion than because it did not involve a debtor named "Smith."

Unlike Lee, Grimmett does not pretend that the revesting issue was not highly relevant to the Ninth Circuit's decision. Rather, he contends that the Ninth Circuit's decision was correct because it followed that court's prior decision in *Hillis*, the "plain language" Bankruptcy Code section 1141, and state law rules of contract interpretation. Each of Grimmett's contentions is unpersuasive.

First, the fact that the Ninth Circuit may have followed its *own* published authority supports granting the Petition. The Ninth Circuit's holding in *Hillis* created a conflict regarding the proper interpretation of section 1141(b), and the decision below has perpetuated that conflict by following *Hillis*.

Second, Grimmett's "plain language" argument is no more persuasive. According to Grimmett, the Ninth Circuit was able to imply a limitation upon the revesting of Smith's assets because section 1141(b) provides that property revests in the reorganized debtor "[e]xcept as otherwise provided in the plan." Grimmett at 6. Grimmett contends that Congress could have made (but did not make) the exception to section

1141(b) more restrictive by providing that property revests "[e]xcept as otherwise **expressly** provided in the plan or the order confirming the plan." *Id.* at 6 (emphasis in original). What Grimmett ignores, however, is that Congress just as easily could have made (but did not make) the exception to section 1141(b) broader by providing that property revests "[e]xcept as otherwise **implicitly** provided in the plan . . . ," which is the reading that the Ninth Circuit adopted in the decision below. The fact is that Congress included *neither* the term "expressly" nor the term "implicitly" in the statute. Unlike the Ninth Circuit, however, a majority of courts have made clear that only specific language in a plan can prevent the revesting of estate assets in the debtor. Petition at 13.

Finally, Grimmett erroneously contends that the question whether Smith's assets revested in him is a matter of state law contract interpretation. Grimmett at 6, 9. To the contrary, what is at issue here is the proper interpretation of a federal statute, which is clearly a matter of federal law. *Molzof v. United States*, 502 U.S. 301, 305 (1992) ("the meaning of . . . a federal statute is a federal question"). The Ninth Circuit's interpretation of section 1141(b), which allows a court to imply a limitation on revesting from ambiguous plan terms, directly conflicts with established rules of statutory interpretation, *see J.E. Mamiye & Sons*, 665 F.2d at 340, and with those cases which have interpreted section 1141(b) to revest estate property in the reorganized debtor upon confirmation unless the plan expressly provides otherwise, *see* Petition at 13-14.

B. Respondents Fail To Refute The Existence Of A Significant Conflict In The Law Of Post-Confirmation Conversion.

Respondent Grimmett *admits* that the decisions below conflict with holdings of the Sixth Circuit and various lower courts. *See* Grimmett at 19 (recognizing that "courts have reached contrary conclusions" and citing, *inter alia*, *In re Chattanooga Wholesale Antiques, Inc.*, 930 F.2d 458 (6th Cir.

1991)).[3] In fact, these "contrary conclusions" represent the *majority* rule. While Grimmett attempts to mischaracterize the majority rule as "illogical," *id.* at 19, he cannot escape the fact that the decision of the courts below directly conflicts with this rule. This Court should grant certiorari in order to resolve this direct conflict among the federal courts.

Given that there is no escaping the clear conflict, Grimmett attempts to diminish the importance of the issues presented in this case, claiming that they are "not of substantial importance." Grimmett at 21. Well respected commentators strongly disagree. *See* Petition at 25-26. As explained by *Norton*, "[t]he failure of the Bankruptcy Code to deal effectively with post confirmation default has led to increasing confusion in the case law," "various reactions by the courts," "mindboggling" results, and "unintended consequences" for creditors and debtors alike. *Norton* § 95:12 Supp. at 172-73.

According to Grimmett, parties can simply draft around the conflict by expressly providing for what happens in the event of a post-confirmation conversion to chapter 7. Grimmett at 21-23. Grimmett's argument proves too much, in that such an argument could be applied to *any* provision of the Bankruptcy Code governing plans of reorganization. Yet, as this Court is aware, plans of reorganization often are not confirmed with the consent of all parties. *See Bank of America N.A. & S.A. v. 203 North LaSalle Street Partnership*, 126 F.3d 955 (7th Cir. 1997), *cert. granted*, 118 S. Ct. 1674 (1998) (this Court to decide confirmability of contested "new value" plan). Thus, it is simply not true that the parties to a bankruptcy case will always be able to agree upon plan provisions that deal with every possible dispute that may

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[3] Contrary to Grimmett, who acknowledges the conflict between the decisions below and the Sixth Circuit's decision in *Chattanooga Wholesale*, Lee contends that no such conflict exists. Lee at 9. Lee is incorrect. Lee quotes out of context the final paragraphs of *Chattanooga Wholesale* that deal with transfers which occurred *prior* to confirmation and, thus, prior to the revesting of the estate's assets in the reorganized debtor. Contrary to Lee's assertion, there was no "asset belonging to the converted Chapter 7 estate." *Id.*

arise, or that the parties could even think of every possible dispute, or that it would make sense for the parties to attempt to draft a plan in such a manner. In this case, Smith did not intend for, and would not have agreed to, any provision that would have allowed those assets which had revested in him upon confirmation to be transferred to a new, chapter 7 estate upon conversion of his case.

Similarly unavailing is Grimmett's contention that this Court should allow Congress to resolve the conflict among the Circuits. Grimmett at 24. Under this logic, this Court should *never* grant certiorari in a bankruptcy case (or in any other case involving federal statutes), since the Court can always wait for Congress to amend the statute to deal with the problem.[4]

The fact is that Congress *did* amend the Bankruptcy Code in 1994 to provide the result that Grimmett seeks, *but only in chapter 13 bankruptcy cases*. Pursuant to a 1994 amendment to Bankruptcy Code section 348(f), when a *chapter 13* case is converted to a chapter 7 case, the assets of the newly created chapter 7 estate consist of all property in the debtor's control at the time of conversion, whether or not those assets had revested in the debtor upon confirmation of the chapter 13 plan. No such provision exists for conversion of chapter 11 cases. *See Norton* § 95:12 Supp. at 174 ("the language of § 348 so clearly fails to address post confirmation conversion" of chapter 11 cases). Since Congress could have, but did not, provide that postconfirmation conversion of chapter 11 cases vests the reorganized debtor's assets in a new chapter 7 estate, the majority line of cases properly holds that Congress

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[4] The Court's recent consideration of the continued vitality of the "new value principle" in *LaSalle Street Partnership* should put this notion to rest. This Court has recognized the significant conflict among the Circuits regarding the new value principle not once, but twice before. *See Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 205 (1988); *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994). Notwithstanding the passage of a decade, Congress failed to act to resolve this obvious conflict. This Court should not accept Grimmett's request to ignore a clear conflict in the hopes that Congress someday might address it.

did not intend for such a result in chapter 11 cases. *See Bates v. United States*, 118 S. Ct. 285, 290 (1997) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposefully in the disparate inclusion or exclusion.") (quotations omitted).

C. The Majority Rule That A Chapter 11 Case May Not Be Converted After Property Has Revested In The Reorganized Debtor Does Not Render Bankruptcy Code Section 1112 Meaningless.

Both Lee and Grimmett contend that, were the Ninth Circuit to have applied the majority rule, it "would make a nullity of 11 U.S.C. § 1112(b)(7) and (8)." Lee at 6; Grimmett at 18. This precise argument has been considered and rejected multiple times by courts adhering to the majority rule. *See, e.g., In re K & M Printing, Inc.*, 210 B.R. 583, 585 (Bankr. D. Ariz. 1997) ("The notion that section 1112(b) is rendered meaningless under the [majority] view is incorrect."); *In re Winom Tool & Die, Inc.*, 173 B.R. 613, 621 (Bankr. E.D. Mich. 1994) ("I therefore reject the trustee's assertion that certain Code provisions or bankruptcy rules would be rendered meaningless if conversion did not divest the debtor of property interests acquired pursuant to § 1141(b)."); *In re T.S.P. Indus.*, 117 B.R. 375, 379 (Bankr. N.D. Ill. 1990) (rejecting argument that majority rule "would render Sections 1112(b)(7) and (8) nullities").

While the ordinary rule under section 1141(b) is that all estate property revests in the reorganized debtor upon confirmation, plans can and do sometimes contain express language preventing the revesting of certain assets. These plans, which differ from the Plan that Smith confirmed, ordinarily would allow for the post-confirmation conversion of a case to chapter 7. This is because, in such cases, there would be assets available to become part of the chapter 7 estate. *See Winom Tool & Die*, 173 B.R. at 621 ("to the extent that the

plan or confirmation order so provides, property of the chapter 11 estate does not vest in the debtor – and hence would become a part of the chapter 7 estate if the case converts").

In this case, property in Smith's chapter 11 estate did revest in him upon confirmation, and there was "no provision [in the Plan] directing that upon conversion, the Court retains jurisdiction over debtor's property." *K & M Printing*, 210 B.R. at 586. Respondents point to language in the Plan providing that, upon default, the Bankruptcy Court could "adjudg[e] the Debtor bankrupt." Petition at 40a. However, neither that language nor any other provision of the Plan authorized the Bankruptcy Court to convert the case and divest Smith of assets which revested in him upon confirmation. Notwithstanding the fact that there were no assets available to become a part of the chapter 7 estate, the courts below failed to follow the majority rule that conversion was not appropriate because it would not be in the best interests of creditors and the estate.

D. The Facts Of This Case Are Not "Unusual."

Grimmett and Lee both attempt to mischaracterize the Ninth Circuit's decision as being based "upon the particular facts in the case." Grimmett at 4. In particular, they stress the Bankruptcy Court's findings that Smith was in default of his obligations under the Plan. It is not the lower courts' fact finding, however, that is at issue here; clearly this Court will not grant certiorari to sort out differing interpretations of the record. Rather, the basis for certiorari in this case is the clear conflict among the courts perpetuated by the holdings below that the revesting provisions of Bankruptcy Code section 1141(b) can be overridden by implication, rather than by specific language in a plan, and that assets which have revested in the reorganized debtor can vest again in the chapter 7 trustee.

There is nothing unique about the factual or procedural posture of this case. The substantial issues of law discussed in the Petition may arise any time that a bankruptcy court finds that a debtor was either unable to substantially consummate

its plan, or was in material default in its obligations under the plan. The myriad case law on the issue illustrates this point. The certworthy issue is whether, assuming those findings to be true, a bankruptcy court may convert a debtor's chapter 11 case to one under chapter 7 when all of the estate's assets have revested in the reorganized debtor. The majority rule is that a court may not convert such a case, as Grimmett admits. Because the courts below held to the contrary, this Court should grant certiorari in order to resolve the "enormous confusion" in this important area of bankruptcy law. *See Norton* § 95:12 at Supp. 172-73.

E. Section 1142 Does Not Provide An Alternative Basis For Affirming The Ninth Circuit's Decision.

Lee contends that the Ninth Circuit could have relied on Bankruptcy Code section 1142 as an alternative basis for its decision. The Ninth Circuit, however, did not even cite section 1142, because nothing in section 1142 authorized the appointment of a trustee and the wholesale divestiture of Smith's revested assets. Section 1142 merely authorizes a bankruptcy court to enter orders that are "necessary for the consummation of the plan" or "to effect a transfer of property dealt with by a confirmed plan." Thus, section 1142 is a tool courts may use to facilitate a plan's implementation. In this case, however, the Plan is *not* being implemented. Rather, the Plan has been usurped entirely by the appointment of a chapter 7 trustee who has distributed Smith's assets without any regard to the terms of the confirmed Plan.

F. This Appeal Is Not Moot.

Lee has argued at every stage of this appeal that this appeal is moot. Lee has failed to prove his point every time. The test of mootness on appeal is whether the appellate court can grant at least some relief to the appellant. *In re Envirodyne Indus.*, 29 F.3d 301, 304 (7th Cir. 1994). Contrary to Lee's assertion, the test is not whether Smith can "guarantee that all of the transactions can be reversed." Lee at 18.

Among other things, Lee acknowledges that the chapter 7 trustee remains in control of more than $300,000 in cash, which cash properly belongs to Smith. A reversal of the Ninth Circuit's decision would return both those funds and control of this case to Smith, thus enabling Smith to deal effectively with the tax and other problems the improper conversion has caused him. Moreover, reversal also would enable Smith to challenge many of the trustee's actions in this case, including the trustee's improper disposition of Smith's assets in contravention of his rights as a revested debtor. Finally, reversal would facilitate Smith's challenge to the substantial fees incurred by the trustee and his professionals. Thus, whether or not Smith is able to challenge the sale of *Daybreak* itself, he will be able to reassert control over his own assets and to avoid further harm due to the substantial delay and expense of the chapter 7 proceedings.

* * *

Smith respectfully requests that this Court grant the Petition.

Respectfully submitted,

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